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PROPERTY BAROMETER

FNB Property Monthly

The FNB House Price Index's year-on-year inflation rate is slightly higher of late, which may be partly the economy, but is largely a Western Cape story

4 July 2016

MARKET ANALYTICS AND SCENARIO FORECASTING UNIT

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In the 2nd quarter of 2016, certain signs suggest a slightly "less weak" South African economy. We believe the national economy to be partly responsible for a mild acceleration in average house price growth since early-2016.

However, the Western Cape Province is largely responsible for an acceleration in the national average house price growth rate, with relatively high levels of confidence in that region having caused it to buck the national house price growth trend for some time to record strong double-digit house price inflation.

KEY POINTS

- *The FNB House Price Index for June 2016 rose by 7.4% year-on-year. This is slightly faster than the revised 7.2% rate recorded for May, extending the recent mild accelerating trend in average house price inflation to 5 months.*

- *Examining house price inflation on a month-on-month basis suggests that a period of slightly better, or slightly "less weak", economic performance during the 2nd quarter of 2016 may have in part fuelled slightly stronger house price growth.*

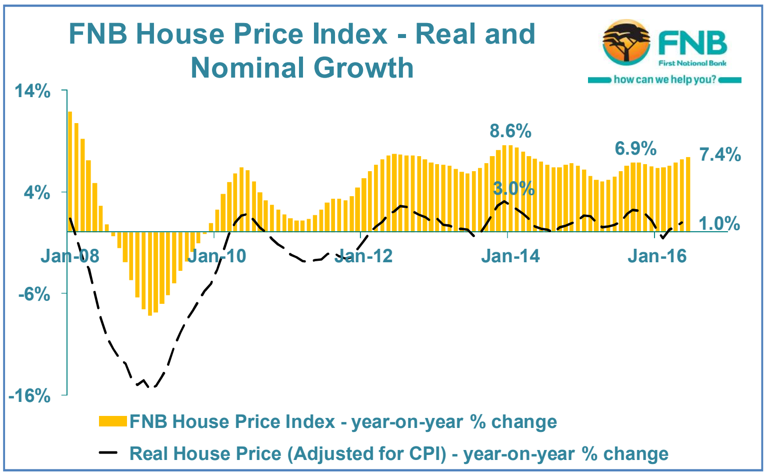
- *But the main driver of the accelerating national average house price inflation rate of late appears to be the Western Cape Province, with 2nd quarter year-on-year house price growth rate of 12.1%, while the other major provinces languish in single-digit price growth territory. Sentiment in and toward the Western Cape appears very positive at present, the region having created a perception of good economic management along with a good lifestyle, thus attracting significant interest from repeat home buyers from other provinces.*

- *Looking forward, the country's Leading Business Cycle Indicators (both OECD and SARB versions) both picked up renewed "downward speed" in year-on-year rates of decline going into the 2nd quarter, after slight improvement (slower rates of decline) earlier in 2016. This suggests that the 3rd quarter may be one of renewed economic deterioration after a slightly better 2nd quarter. We would thus not expect any sustained strengthening in national house price inflation, but how long the Western Cape's price growth acceleration can continue remains the key "wildcard".*

JUNE FNB HOUSE PRICE INDEX FINDINGS

JUNE AVERAGE HOUSE PRICE GROWTH

The FNB House Price Index for June 2016 rose by 7.4% year-on-year. This is slightly faster than the revised 7.2% rate recorded for May, extending the recent mild accelerating trend in average house price inflation to 5 months.



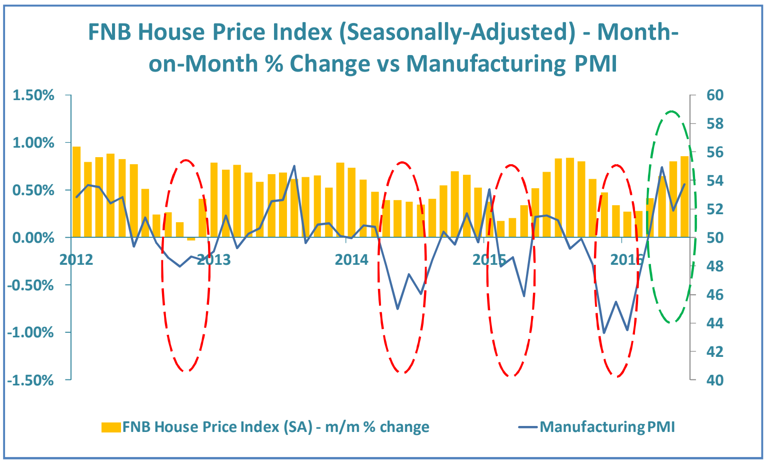
In real terms, when adjusting for CPI (Consumer Price Index) inflation, the rate of house price growth remains mildly positive, having recorded 1.0% in May, the result of a combination of 7.2% average house price inflation and 6.1% Consumer Price Index (CPI) inflation (June CPI data not yet available).

Positive real house price inflation continues to suggest a market still very well balanced between supply and demand. However, it must be said that in times of weak economic growth and rising interest rates there exists the risk that the market can move away from a declining equilibrium price.

The average price of homes transacted in June was R1,079,613.

A PERIOD OF SLIGHTLY "LESS WEAK" ECONOMIC PERFORMANCE SEEMS TO BE A PARTIAL CONTRIBUTOR TO SLIGHTLY STRONGER HOUSE PRICE GROWTH

Examining house price growth on a month-on-month basis suggests that a period of slightly better, or slightly "less weak", economic performance during the 2nd quarter of 2016 may have fuelled slightly stronger house price growth.



While the economy's condition remains poor, and the ongoing risk of recession remains high, certain key economic indicators pointed to a slightly better economic period during the 2nd quarter compared with the dismal 1st quarter.

One such indicator is the Barclays Manufacturing Purchasing Managers Index (PMI), which has shifted back up to a level above the crucial 50 mark (scale 0 to 100). Above a level of 50 suggests a probably expansion in Manufacturing output. South Africa's large Manufacturing Sector is normally a good barometer of the direction of the broader economy, albeit not an exact science. And on a month-on-month seasonally-adjusted basis, average house price growth fluctuations of recent years have broadly tracked the frequent dips and surges in the Manufacturing PMI.

After a prior dip, the broad improvement in the PMI to above the 50 level for the past 4 months more-or-less co-incided with an acceleration in month-on-month seasonally adjusted house price inflation from a low of 0.27% in January to 0.85% by June

Other, perhaps more "leading" indicators had earlier pointed to such a possible 2nd quarter economic improvement. The OECD's version of the South African Leading Business Cycle Indicator, while certainly not pointing to a satisfying economic situation, saw its rate of year-on-year decline subside slightly from a low of

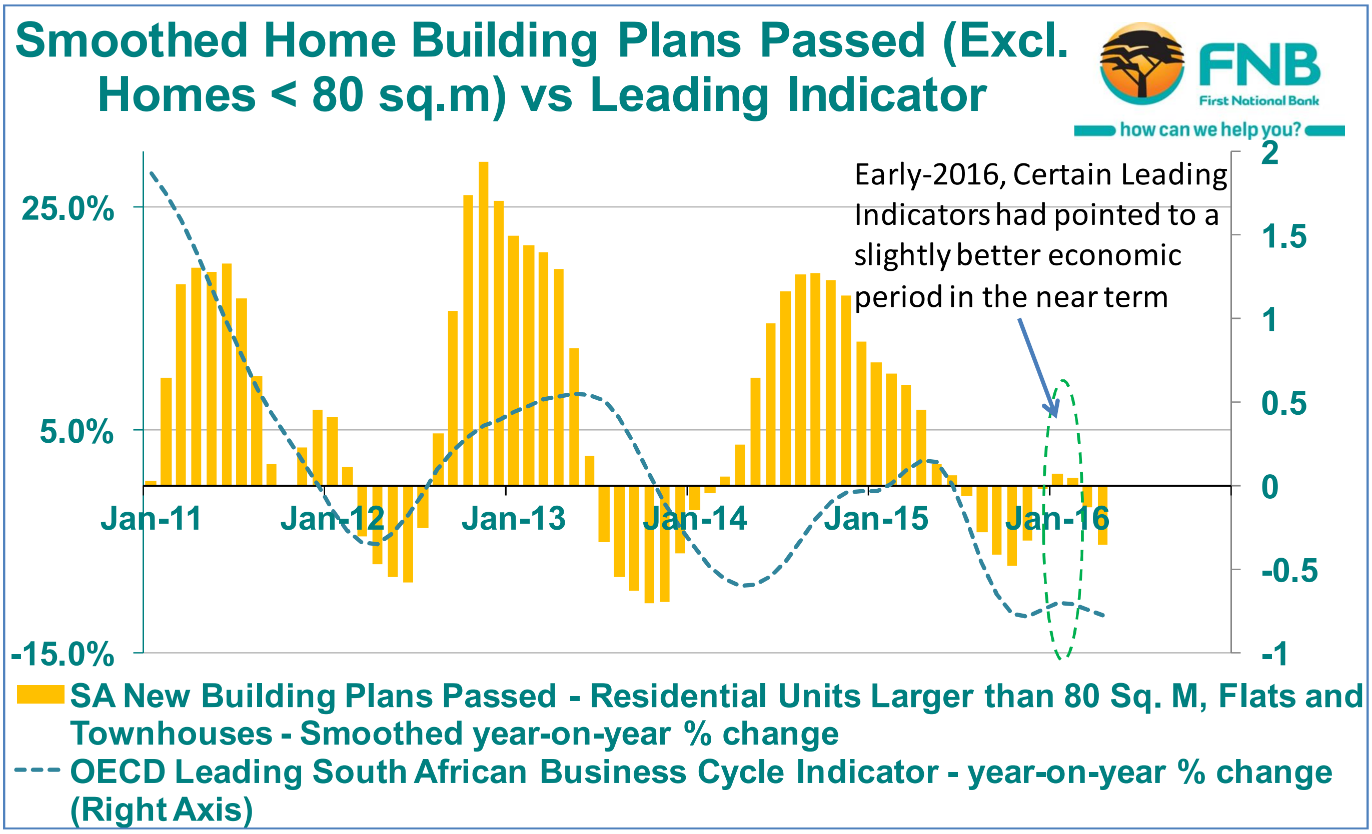
-0.78% as at November 2015 to -0.7% by January 2016. The SARB's (South African Reserve Bank) own version of the Leading Indicator also showed such a diminishing in the pace of year-on-year decline around the same time.

One of the variables included in such Composite Leading Business Cycle Indicators is that of Residential Building Plans Passed excluding "dwelling houses" smaller than 80 square metres, a leading economic indicator more directly related to the housing market. The time series is quite rough, so we have smoothed it very lightly with a statistical smoothing function. The smoothed plans passed data also suggested slight economic improvement to come around the 2nd quarter perhaps, having moved from a noticeable year-on-year decline in the 2nd half of 2015 to slightly positive growth early in 2016.

Therefore, while South Africa's economic performance remains dismal at best, the slightly stronger average house price growth of recent months may be in part explained by a slightly "less weak" economic performance compared to the 1st quarter of 2016.

Looking forward, however, the Leading Indicators don't point towards an improved economic situation holding up. More recently, our smoothed Residential Building Plans Passed series has moved back into year-on-year decline, while both the OECD and SARB Leading Indicators have once again begun to show accelerations in year-on-year rates of decline, suggesting that the economy remains in trouble, and recession risk remains high.

Therefore, we would not expect the recent months' national house price acceleration to last for any significant length of time, assuming a "rational" market that continues to more-or-less track economic fluctuations.



HOUSE PRICE GROWTH APPEARS LARGELY A WESTERN CAPE STORY

In addition to a slightly better 2nd quarter economic situation, we see the "flourishing" Western Cape region as the key driver of overall national house price growth. The province's hard-earned reputation as well-run, and a place with the combination of significant economic opportunity plus good lifestyle, has boosted confidence towards it amongst property investors, while also attracting a strong net inward migration of repeat home buyers in recent years.

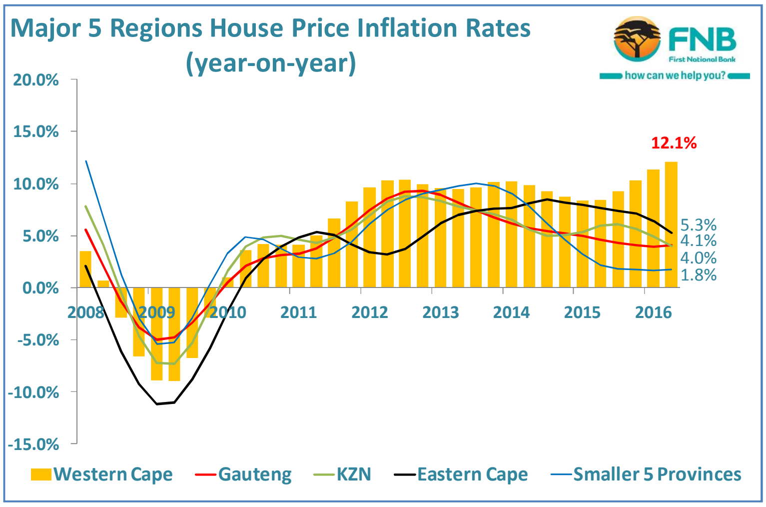
The result has been that this province's residential market has "bucked the national trend" of recent times, showing solid double-digit house price growth where others have been languishing in single digits.

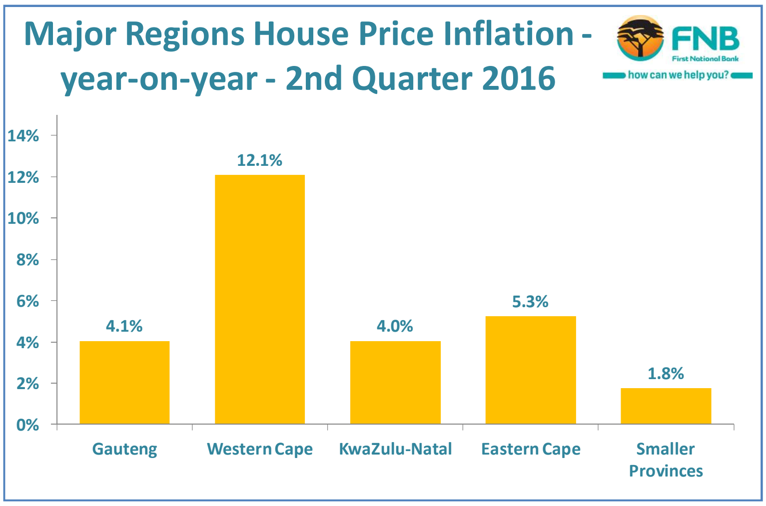
For the entire 2nd quarter of 2016, the national average house price inflation rate was 7.1% year-on-year, up from 6.4% in the 1st quarter.

By comparison, the Western Cape Province saw a far higher 12.1% year-on-year house price inflation, up further from 11.4% in the 1st quarter, and representing the 5th consecutive quarter of acceleration.

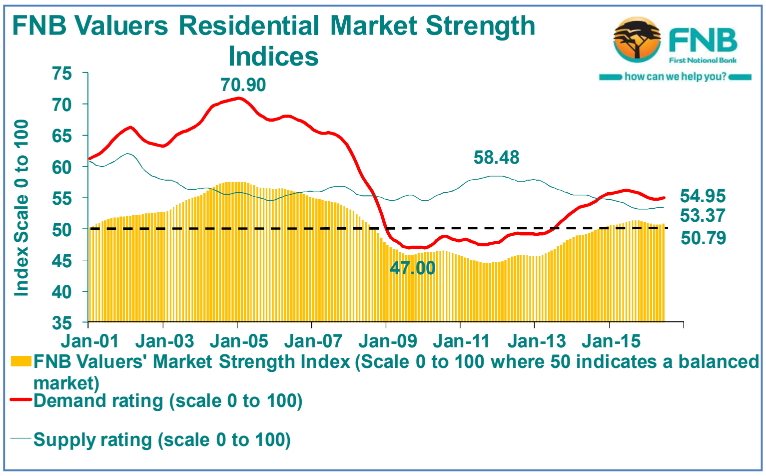
Of the major provinces, Gauteng's house price growth also showed a very slight 2nd quarter acceleration, but off a very low base, from 3.9% year-on-year in the 1st quarter of 2016 to 4.1% in the 2nd quarter. The other 2 major provinces, namely KZN and Eastern Cape, both showed slower house price growth in the 2nd quarter compared to the 1st quarter, to the tune of 4% and 5.3% respectively.

Our FNB "Smaller 5 Provinces" showed the slowest growth of 1.8% year-on-year in the 2nd quarter of 2016





FNB'S VALUERS MARKET STRENGTH INDEX VERY SLIGHTLY STRONGER OF LATE

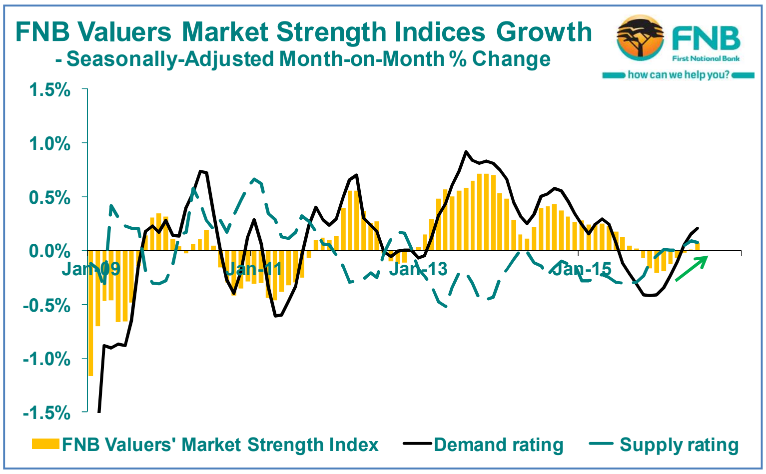


FNB's valuers, in their FNB Valuers Market Strength Index (MSI) (Explanatory notes on Page 10) appeared to support the notion of a slightly stronger market in recent months, compared to earlier in 2016.

The MSI appears to be more of a "co-inciding to lagging" indicator of the residential market, unlike the more leading nature of certain key indicators gleaned from the FNB Estate Agent Survey.

Examining the Demand Rating, Supply Rating and MSI itself, which reflects the difference between Demand and Supply, we see a still well balanced residential market.

The Valuers' Residential Demand Rating was at a level of 54.95 in June (scale 0 to 100), while the Supply Rating was at a lesser 53.37. This translates into an MSI of 50.79, with the level of above 50 implying that residential demand is still perceived to be stronger than supply.



However, the rate of change in the indices is often insightful too.

On a month-on-month seasonally-adjusted basis, after having been in decline for some time the Residential Demand Index has risen mildly in the months April to June 2016.

A slightly faster rise in the Demand Rating compared to an also rising Supply rating has led to a small positive growth rate in the Seasonally-Adjusted MSI during May and June, after a prior 7 month long decline.

CONCLUSION

What do we conclude from our monthly housing market indicators? The 2nd quarter of 2016 was a slightly stronger quarter for the residential market than the 1st quarter on a seasonally-adjusted basis. This can probably be explained by 2 key factors. Firstly, certain leading indicators early in 2016 pointed to the possibility of a slightly better economic period in the near term, and an improved Manufacturing PMI in the 2nd quarter suggests that this slight improvement may well have happened.

However, the Leading Indicators don't suggest that such improvement can be expected to last for any length of time. Both the SARB and OECD versions of the South African Leading Business Cycle Indicator once again picked up "downward speed" in the year-on-year rates of decline going into the 2nd quarter of 2016, as did that residential-related leading indicator, namely Housing Plans Passed excluding Dwelling Houses smaller than 80 sq.m.

FNB's Valuers, in the FNB Valuers' Market Strength Index, appeared to confirm a slightly stronger market on a seasonally-adjusted basis in recent months.

Important, too, is not to place too much emphasis on signs of economic improvement. When we state that the 2nd quarter of 2016 may have been mildly better economically than the 1st quarter, perhaps a better way of putting it would be "less weak". The economy remains in a dismal state.

The major contributor to the acceleration in the national house price inflation rate, therefore, is believed to be a very strong performance in the Western Cape Province, with the national economy being the minor partner.

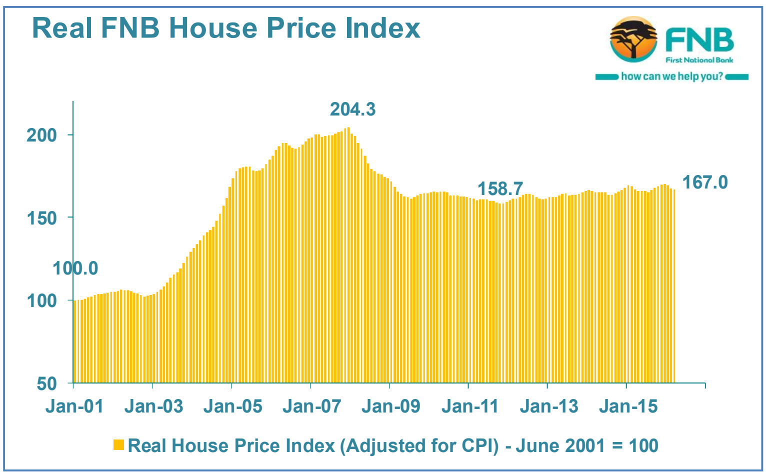
KEY MONTHLY AFFORDABILITY INDICATORS

REAL HOUSE PRICE LEVELS

Examining the longer term real house price trends (house prices adjusted for CPI inflation), we see that the level as at May 2016 was +5.8% up on the October 2011 post-recession low.

However, the average real house price level remains -17.8% below the all time high reached in December 2007 at the back end of the residential boom period.

Looking back further though, the average real price currently remains 67.1% above the January 2001 level, around 15 years ago, and a time back just before boom-time price inflation

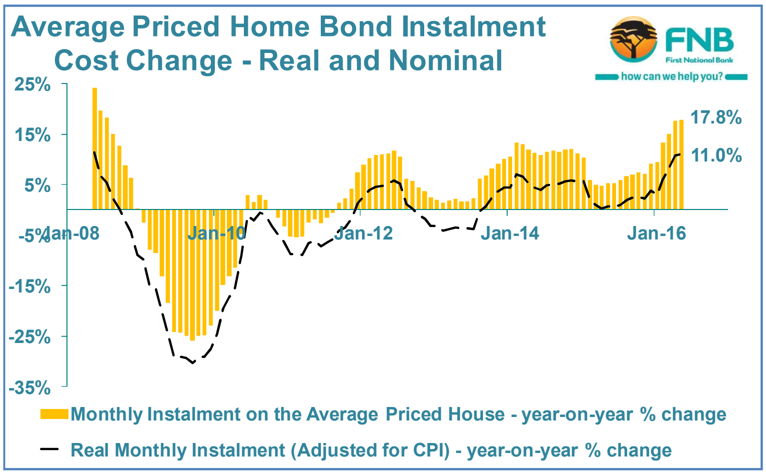


started to accelerate rapidly. We therefore still regard current real price levels as very high.

In nominal terms, when not adjusting for CPI inflation, the average house price in June 2016 was 303.9% above the January 2001 level.

AVERAGE HOUSE PRICE BOND INSTALMENT TREND

In such a credit dependent market, it is important to understand what the rate of change in the monthly bond instalment is, given changes in both house prices and mortgage lending rates.



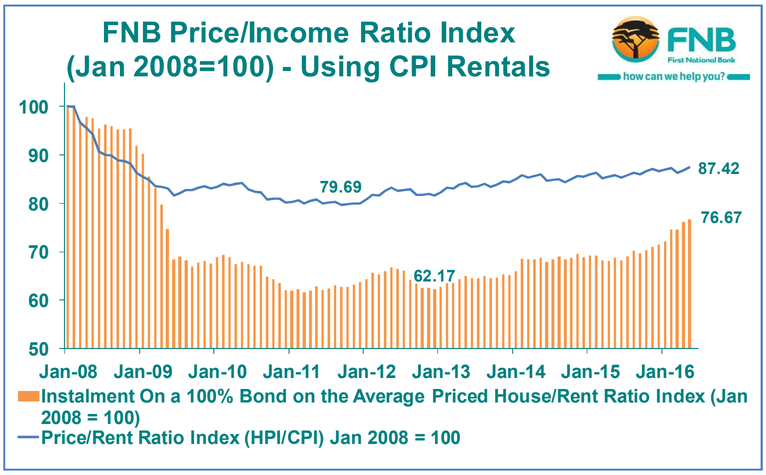
Using a Prime Rate series, along with Mortgage Originator Ooba's time series for Mortgage Loans' Average Differential from Prime, we calculate an "average mortgage lending rate and apply it to our average house price series to obtain an average monthly bond instalment estimate.

A further 50 basis point interest rate hike by the SARB (Reserve Bank) in January, and another 25 basis point hike in March, some increase in the average differential above Prime Rate charged on mortgage loans (using Ooba data), and mildly faster average house price growth of late, have all contributed to a move into double-digit bond instalment inflation on the average priced home in recent months.

In May 2016, the year-on-year inflation rate in the bond instalment on the average-priced home measured 17.8%, slightly faster than the 17.6% rate for April. In real terms, adjusting for CPI inflation, that May bond instalment inflation rate was a very significant 11% (June CPI data not yet available).

PRICE-RENT RATIO

The Price-Rent Ratio is one important ratio in determining how costly the home buying option is relative to the competing option, i.e rental.



Analysts often become concerned when the Price-Rent Ratio is very high, as it can begin to make the rental option very appealing, contributing at some stage into a drop in home buying and a fall in house prices.

House price booms typically take this ratio higher.

To this effect, we use the FNB House Price Index and the CPI for Actual rentals. We show it in index form (because the CPI is an index), with January 2008=100.

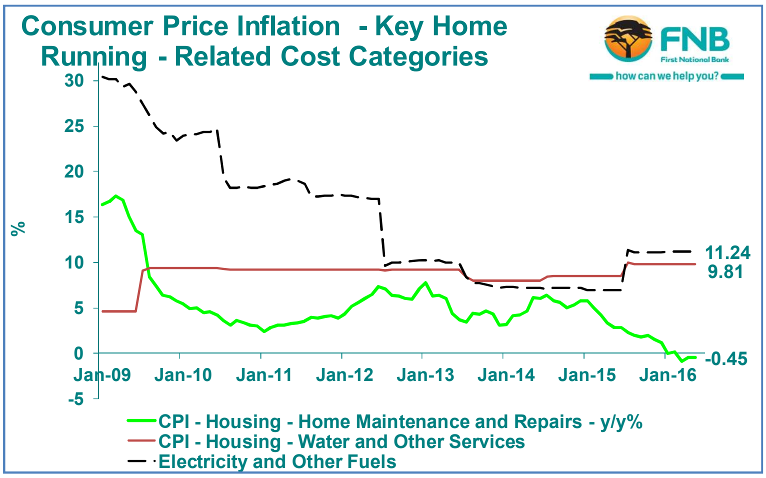
Given that January 2008 was right at the end of the real house price boom, we believe that it represented an extremely high level in the Price-Rent Ratio. After a drop through 2008/9, and again in 2011, the index began to rise gradually as the residential market strengthened. The index was at 87.42 in May 2016, up 9.7% from September 2011.

While 87.42 is believed to still be a high number, the other important ratio, i.e. the Instalment on a 100% bond on the average-priced house/Rent Ratio Index, is far lower. It has been kept far below January 2008 levels by a sharp drop in interest rates from late-2008. It reached a low of 62.17 as at December 2012. However, the combination of house price inflation broadly out-pacing rental inflation, along with gradual interest rate hiking over the past 2 years, has taken this ratio 23.8% higher by May 2016, to a reading of 76.67.

This remains well-below the January 2008 100 level though, as interest rates are still at relatively low levels. But, of course, rates have been in the process of rising, gradually reducing the attractiveness of the home buying option relative to rental in recent years.

HOME OPERATING COST-RELATED INFLATION

The surveys of the CPI sub-indices for "Water and Other Services" (which includes municipal assessment rates) and "Electricity and other fuels" were not done in the May CPI data. Their year-on-year inflation rates therefore remain unchanged at 9.81% and 11.24% respectively, remaining troublesomely above CPI inflation, and contributing significantly to housing-related affordability deterioration.



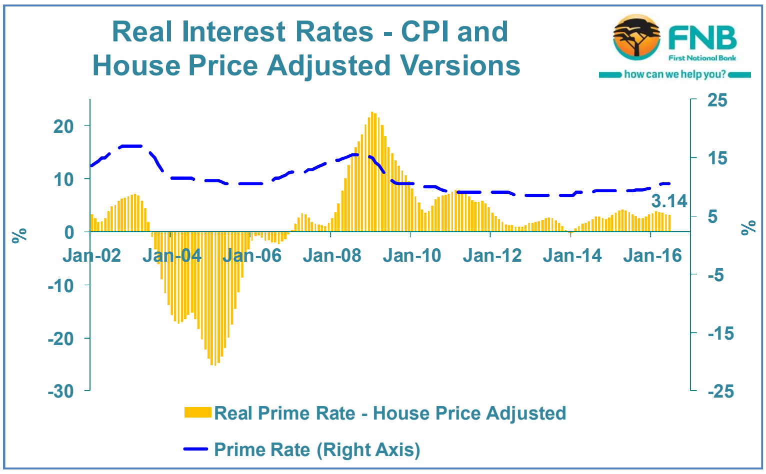
The CPI for Home Maintenance, however, shows a distinct lack of pricing power in the Home Maintenance-related sectors of the economy. In May, this index's year-on-year rate of change remained negative to the tune of -0.45%.

REAL ALTERNATIVE PRIME RATE AND POTENTIAL FOR A SPECULATORS' MARKET

Ongoing interest rate hikes, with the most recent one having been a 25 basis point rise in March, continue to keep the market largely away from the speculator.

In order to create a "speculator's paradise" in residential property, it is important to have price growth at a percentage significantly faster than the percentage of the annual interest charged on a mortgage loan.

Such an environment would give rise to widespread use of cheap credit to buy and sell properties in a relatively short space of time and make big capital gains. 2004-5 was such a speculators' paradise.



To monitor this, we calculate our very simple "Alternative Real Prime Rate", which adjusts Prime Rate to real terms using average house price inflation instead of the usual CPI inflation rate approach.

For a healthy market with low levels of speculation, we believe that this real rate should remain positive. Indeed, that was again the case in June, where the Real Alternative Prime Rate was 3.14%, having risen in recent times on the back of further interest rate hiking along with slowing house price inflation. We thus believe the SARB's monetary policy stance to be appropriate currently from a residential market health point of view.

Monthly FNB House Price Index (Jan 2001 = 100)

FNB First National Bank

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Date	Index	y/y % change	Date	Index	y/y % change	Date	Index	y/y % change	Date	Index	y/y % change
Jan-01	100.0		Jan-05	209.7	36.1%	Jan-09	272.8	-7.6%	Jan-13	317.88	6.7%
Feb-01	100.7		Feb-05	215.4	36.3%	Feb-09	270.7	-8.2%	Feb-13	321.34	6.6%
Mar-01	101.4		Mar-05	219.6	35.6%	Mar-09	269.5	-7.9%	Mar-13	325.00	6.5%
Apr-01	102.4		Apr-05	221.7	34.3%	Apr-09	268.6	-7.1%	Apr-13	327.77	6.3%
May-01	103.6		May-05	222.0	32.5%	May-09	267.5	-6.2%	May-13	329.41	5.9%
Jun-01	104.7		Jun-05	221.7	30.4%	Jun-09	267.8	-5.1%	Jun-13	330.65	5.8%
Jul-01	105.3		Jul-05	221.1	27.9%	Jul-09	269.2	-3.8%	Jul-13	331.90	6.0%
Aug-01	105.6	10.0%	Aug-05	221.3	25.0%	Aug-09	271.4	-2.9%	Aug-13	333.38	6.3%
Sep-01	106.0	9.2%	Sep-05	222.3	21.9%	Sep-09	273.8	-2.0%	Sep-13	335.14	6.8%
Oct-01	106.5	8.9%	Oct-05	224.5	19.1%	Oct-09	275.5	-1.1%	Oct-13	337.08	7.4%
Nov-01	107.3	9.0%	Nov-05	227.3	16.2%	Nov-09	276.6	-0.2%	Nov-13	339.22	8.1%
Dec-01	108.6	9.5%	Dec-05	231.0	13.9%	Dec-09	277.6	0.9%	Dec-13	342.14	8.6%
Jan-02	110.2	10.2%	Jan-06	235.3	12.2%	Jan-10	278.9	2.3%	Jan-14	345.10	8.6%
Feb-02	112.2	11.4%	Feb-06	240.0	11.4%	Feb-10	281.0	3.8%	Feb-14	348.19	8.4%
Mar-02	114.1	12.6%	Mar-06	244.2	11.2%	Mar-10	282.8	4.9%	Mar-14	350.75	7.9%
Apr-02	115.6	12.9%	Apr-06	247.4	11.6%	Apr-10	284.0	5.8%	Apr-14	352.40	7.5%
May-02	116.5	12.4%	May-06	248.9	12.1%	May-10	284.5	6.4%	May-14	353.28	7.2%
Jun-02	116.8	11.6%	Jun-06	249.3	12.5%	Jun-10	284.0	6.1%	Jun-14	353.59	6.9%
Jul-02	117.0	11.2%	Jul-06	249.9	13.0%	Jul-10	282.7	5.0%	Jul-14	353.83	6.6%
Aug-02	117.2	10.9%	Aug-06	251.1	13.5%	Aug-10	282.1	3.9%	Aug-14	354.64	6.4%
Sep-02	117.4	10.7%	Sep-06	252.9	13.8%	Sep-10	282.4	3.2%	Sep-14	356.64	6.4%
Oct-02	117.9	10.7%	Oct-06	255.1	13.6%	Oct-10	282.9	2.7%	Oct-14	359.36	6.6%
Nov-02	118.7	10.6%	Nov-06	257.7	13.4%	Nov-10	282.8	2.2%	Nov-14	362.16	6.8%
Dec-02	119.8	10.3%	Dec-06	260.8	12.9%	Dec-10	282.6	1.8%	Dec-14	364.48	6.5%
Jan-03	121.1	9.9%	Jan-07	263.9	12.1%	Jan-11	282.8	1.4%	Jan-15	366.29	6.1%
Feb-03	123.2	9.8%	Feb-07	266.3	11.0%	Feb-11	284.2	1.2%	Feb-15	367.60	5.6%
Mar-03	125.7	10.2%	Mar-07	268.1	9.8%	Mar-11	286.1	1.2%	Mar-15	368.84	5.2%
Apr-03	128.5	11.1%	Apr-07	269.7	9.0%	Apr-11	287.8	1.3%	Apr-15	370.08	5.0%
May-03	131.1	12.5%	May-07	271.9	9.2%	May-11	289.3	1.7%	May-15	371.43	5.1%
Jun-03	133.6	14.4%	Jun-07	274.8	10.2%	Jun-11	290.3	2.2%	Jun-15	373.06	5.5%
Jul-03	136.3	16.5%	Jul-07	277.7	11.1%	Jul-11	291.0	3.0%	Jul-15	375.18	6.0%
Aug-03	138.6	18.3%	Aug-07	280.6	11.8%	Aug-11	291.5	3.3%	Aug-15	377.73	6.5%
Sep-03	140.9	20.0%	Sep-07	283.6	12.1%	Sep-11	291.7	3.3%	Sep-15	381.11	6.9%
Oct-03	143.6	21.8%	Oct-07	287.0	12.5%	Oct-11	291.9	3.2%	Oct-15	384.01	6.9%
Nov-03	146.8	23.6%	Nov-07	290.8	12.9%	Nov-11	292.9	3.6%	Nov-15	386.33	6.7%
Dec-03	150.4	25.5%	Dec-07	293.9	12.7%	Dec-11	294.9	4.4%	Dec-15	388.09	6.5%
Jan-04	154.1	27.2%	Jan-08	295.3	11.9%	Jan-12	297.8	5.3%	Jan-16	389.56	6.4%
Feb-04	158.1	28.3%	Feb-08	294.9	10.7%	Feb-12	301.3	6.0%	Feb-16	391.09	6.4%
Mar-04	161.9	28.8%	Mar-08	292.6	9.1%	Mar-12	305.1	6.6%	Mar-16	392.94	6.5%
Apr-04	165.1	28.5%	Apr-08	289.0	7.1%	Apr-12	308.5	7.2%	Apr-16	395.38	6.8%
May-04	167.6	27.9%	May-08	285.2	4.9%	May-12	311.0	7.5%	May-16	398.02	7.2%
Jun-04	169.9	27.2%	Jun-08	282.0	2.6%	Jun-12	312.6	7.7%	Jun-16	400.53	7.4%
Jul-04	172.8	26.8%	Jul-08	279.9	0.8%	Jul-12	313.2	7.6%			
Aug-04	177.0	27.7%	Aug-08	279.4	-0.4%	Aug-12	313.5	7.6%			
Sep-04	182.3	29.4%	Sep-08	279.3	-1.5%	Sep-12	313.8	7.6%			
Oct-04	188.5	31.3%	Oct-08	278.6	-2.9%	Oct-12	313.7	7.5%			
Nov-04	195.6	33.3%	Nov-08	277.1	-4.7%	Nov-12	313.9	7.2%			
Dec-04	202.9	34.9%	Dec-08	275.1	-6.4%	Dec-12	315.1	6.9%			

ADDENDUM - NOTES:

Note on The FNB Average House Price Index: Although also working on the average price principle (as opposed to median or repeat sales), the FNB House Price Index differs from a simple average house price index in that it could probably be termed a "fixed weight" average house price index.

One of the practical problems we have found with house price indices is that relative short term activity shifts up and down the price ladder can lead to an average or median price index rising or declining where there was not necessarily "genuine" capital growth on homes. For example, if "Full Title 3 Bedroom volumes remain unchanged from one month to the next, but Sectional Title 1 Bedroom and Less (the cheapest segment on average) transaction volumes hypothetically double, the overall national average price could conceivably decline due to this relative activity shift.

This challenge of activity shifts between segments is faced by all constructors of house price indices. In an attempt to reduce this effect, we decided to fix the weightings of the FNB House Price Index's sub-segments in the overall national index. This, at best, can only be a partial solution, as activity shifts can still take place between smaller segments within the sub-segments. However, it does improve the situation.

With our 2013 re-weighting exercise, we have begun to segment not only according to room number, but also to segment according to building size within the normal segments by room number, in order to further reduce the impact of activity shifts on average price estimates.

The FNB House Price Index's main segments are now as follows:

• The weightings of the sub-segments are determined by their relative transaction volumes over the past 5 years, and will now change very slowly over time by applying a 5-year moving average to each new price data point. The sub-segments are:

- Sectional Title:
    - Less than 2 bedroom – Large
    - Less than 2 bedroom – Medium
    - Less than 2 bedroom – Small

    - 2 Bedroom – Large
    - 2 bedroom – Medium
    - 2 bedroom – Small

    - 3 Bedroom and More - Large
    - 3 Bedroom and More - Medium
    - 3 Bedroom and More - Small

- Full Title:
    - 2 Bedrooms and Less - Large
    - 2 Bedrooms and Less - Medium
    - 2 Bedrooms and Less - Small

    - 3 Bedroom - Large
    - 3 Bedroom - Medium
    - 3 Bedroom - Small

    - 4 Bedrooms and More - Large
    - 4 Bedrooms and More - Medium
    - 4 Bedrooms and More – Small

The size cut-offs for “small”, medium” and “large” differ per room number sub-segment. “Large” would refer to the largest one-third of homes within a particular room number segment over the past 5 year period, “Medium” to the middle one-third, and “Small” to the smallest one-third of homes within that segment.

- The Index is constructed using transaction price data from homes financed by FNB.
- The minimum size cut-off for full title stands is 200 square metres, and the maximum size is 4000 square metres
- The maximum price cut-off is R10m, and the lower price cut-off is R20,000 (largely to eliminate major outliers and glaring inputting errors).
- The index is very lightly smoothed using a Hodrick-Prescott smoothing function with a Lambda of 5.

ADDENDUM - NOTES:

Note on the FNB Valuers’ Market Strength Index: *When an FNB valuer values a property, he/she is required to provide a rating of demand as well as supply for property in the specific area. The demand and supply rating categories are a simple “good (100)”, “average (50)”, and “weak (0)”. From all of these ratings we compile an aggregate demand and an aggregate supply rating, which are expressed on a scale of 0 to 100. After aggregating the individual demand and supply ratings, we subtract the aggregate supply rating from the demand rating, add 100 to the difference, and divide by 2, so that the FNB Valuers’ Residential Market Strength Index is also depicted on a scale of 0 to 100 with 50 being the point where supply and demand are equal.